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FOREIGN EXCHANGE MANAGEMENT IN NIGERIA PAST, PRESENT AND THE FUTURE [1]

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The paper examined foreign exchange management in Nigeria during the period prior to and since the introduction of the Structural Adjustment Programme (SAP), and outlined the prospects for foreign exchange management in the future. It highlighted factors that need to be reversed by appropriate policies if a crisis-free and more relaxed foreign exchange management mechanism is to evolve.

The major findings of the paper include the inability of exchange control measures adopted before the commencement of SAP to turn around the external sector of the economy, especially since 1982 when Nigeria started to experience serious foreign exchange problems. The reasons adduced were that exchange controls, were not applied consistently, they needed a lot of policing and were often subject to large scale corruption which derailed the system. Another reason was that the administered exchange rate mechanism adopted during this period led to the overvaluation of the Naira exchange rate.

In an attempt to correct the serious disequilibrium in the external sector of the economy and evolve a more rational basis for foreign exchange management, the control system was replaced with a market based system with the introduction of the Structural Adjustment Programme in July 1986. Under the Programme, exchange controls on current account transactions have been dismantled and the exchange rate for the Naira is now determined through an auction system based on market forces. The main achievements of the new system are the elimination of payments arrears that proved difficult to tackle during the exchange control era, the increase in domestic capacity utilisation due to the increased local sourcing of raw materials, elimination of the over-valuation of the naira exchange rate, improvement in the composition of non-oil exports and relatively more relaxed atmosphere for foreign exchange management. However, the problems of foreign exchange inadequacy, dependence on the oil sector for foreign exchange earnings, continuous depreciation of the Naira exchange rate and the attendant inflationary expectations are yet to be resolved.

In order to find solutions to some of these problems, the exchange rate for the naira should be determined within a band to ensure stability while still relying on market forces; demand management policies should continue to be restrictive to achieve stability in the short run while supply side measures to increase foreign exchange receipt should be pursued as both a medium and long term objective.

Introduction

Foreign exchange is a means of effecting payments for international transactions. It can be acquired by a country through; the export of goods and services, direct investment inflow, draw down on external loans, aids and grants and it can be expended to settle international obligations. When foreign exchange expenditure is lower than foreign exchange receipts, the surplus is added to reserves. These reserves which are also savings from foreign exchange

1 The views expressed in this paper are those of the author and do not necessarily reflect the position of the Central Bank of Nigeria. While the paper benefitted immensely from the comments by Messrs S.E. Omoruyi, E.U. Olisadebe, J.O. Asogu, O.E. Essien, F.O. Odoko, F.C.O. Analogbei and Mrs. O.O. Akanji, any material defect remains that of the author. The author will also want to note that the persistent demand by the editorial board that the earlier draft of this paper be revised influenced the early completion of this work..

transactions are held by the authorities to finance shortfalls in foreign exchange receipts and to safeguard the international value of the domestic currency.

For most developing countries that need to import raw materials and spare parts for the purpose of economic development, foreign exchange reserves, fore build-up is required to ensure that panic measures are not resorted to when foreign exchange receipts are dwindling.

When there is a disequilibrium in the foreign exchange market caused by inadequate supply of foreign exchange reserves, pressure may be exerted on foreign exchange reserves. If the reserves are not adequate, this may deteriorate into balance of payments problems. There is, therefore, need to manage a nation's foreign exchange resources so as to reduce the adverse effects of foreign exchange volatility. The management of foreign exchange resources is further informed by the need to set an appropriate clearing price in the foreign exchange market that would guarantee adequacy of supply in relation to the demand for foreign exchange. Therefore, the art of foreign exchange management is a conscious attempt to harness foreign exchange resources, deploy them to service the economy and to meet other international commitments while saving some to raise the level of the country's international reserves so as to prevent the economy from experiencing shocks due to foreign exchange volatility.

The aim of the paper is to analyse and describe the past method of foreign exchange management in Nigeria, the current dispensation and the possible direction that could be followed in the future. Part one of the paper briefly examines the theoretical concept of the subject and stresses the role of foreign exchange management in ensuring balance of payments equilibrium. In part two, foreign exchange management in the pre-SAP era is analysed. The SAP dispensation is dealt with in part three. Part four appraises policy measures under SAP including prospects for the future. Policy recommendations are contained in part five while part six concludes and summarises the paper.

PART 1
THEORETICAL BACKGROUND

Foreign exchange resources are derived and expended in the course of effecting economic transactions between the residents of one country and the rest of the world. In this sense, there is a close link between foreign exchange transactions and the balance of payments. While foreign exchange transactions reflect cash flows arising from international operations, the balance of payments looks at the actual movement of goods, services and changes in financial assets and liabilities. When adjustments are made to cash flow statements arising from international transactions in foreign exchange, they are brought to the balance of payments standard. The state of foreign exchange reserves has implication for the ability to finance temporary payments difficulties. In the light of the above, we shall examine the issue of foreign exchange management largely on the basis of the theoretical formulations of the approaches to the balance of payments. These are discussed below

The Elasticity Approach

This approach analyses the effect of devaluation on the trade balance. The proponents of the approach advanced that with adequate downward adjustment of exchange rates, countries with balance of payments difficulties would be able to export more, import less and save some foreign exchange. However, this was based on rigid assumptions of mass unemployment,

perfectly elastic supplies, an initial balanced growth and the assumption that the elasticities of home and foreign demand for imports should exceed unity.[2]

Devaluation per se may not be adequate for developing countries where relative prices are not the sole determinants of international trade. However, the elasticity approach prescribed complementary fiscal/monetary policies which could be adopted in place of devaluation to achieve the same result. In this case, there is a direct attempt to manipulate the major items of the balance of trade rather than relative prices to stimulate exports and curtail imports. Prior to the inception of SAP, a passive exchange rate mechanism was maintained. Although exchange rates were not static, they were not active. The policy of gradual appreciation from 1982 was not informed by underlying market situations. The prevalence of exchange controls during this period relegated to the background, the application of the prescriptions of policies under the elasticity approach. Exchange control rather than relative price adjustment was the main focus of policy.

Income-Absorption Approach

The realisation that elasticities include both price and income influences shifted emphasis to the development of a framework that relates income to expenditure by introducing income into the partial analysis of the elasticity approach. The popular identify of the absorption approach relates the trade balance to total output and total absorption. For devaluation to improve the trade balance, output must be greater than absorption. This is because devaluation is supposed to reduce the external value of domestic money supply and the value of domestic spending.[3] However, if the demand for foreign exchange is accelerating and the monetary authorities continue to exchange domestic cash balances for foreign exchange by drawing down their international reserves, the foreign exchange situation will continue to be precarious.

This approach acknowledges that under extreme circumstances, direct control measures could be applied to reduce foreign exchange disbursements.

The principal measures it recommends are the financing of temporary deficits where reserves are large, trade and exchange controls as well as domestic credit restrictions and devaluation where deficits are persistent and foreign exchange outflow is excessive. The income-absorption approach was partially relied upon by the authorities to manage Nigeria's foreign exchange resources before SAP. However, large scale devaluation of the naira was not embarked upon until SAP came into place. Although the approach prescribes the use of exchange controls in extreme circumstances, it was nevertheless, a deliberate policy framework since 1962. The prescriptions of expenditure changing policies were applied. However, since the commencement of the SAP, the income-absorption approach has been a major determinant of measures designed to turn around the external sector of the economy.

2 IMF – The monetary Approach to the Balance of Payments, IMF, WASHINGTON DC. 1977, p.149.

3 Stern R.M. - Theory and Economic Policy. The Macmillan Press Ltd. London and Basingstoke, 1973 p.214.

The Monetary Approach

The monetary approach emphasised the role of money in shaping other aggregates that influence foreign exchange movement and international reserves. This approach did not categorise expenditure like the preceding approach. It sees income and aggregate expenditure as either the accumulation or decumulation of reserves assets. It therefore considers the overall reserves movement as the policy variable. This is unlike the other two approaches that concentrated on the trade balance. The monetary approach also disagrees with the assumption that monetary effects of surpluses or deficits in the balance of payments are sterilised by the monetary authorities. It holds that the inflow and outflow of foreign exchange associated with surpluses and deficits in the balance of payments are not immediately sterilised, hence they influence aggregate money supply.[4] Furthermore, the monetary approach assumes that when the exchange rate is fixed, the monetary authorities can control the foreign or international reserves component of the monetary base through appropriate credit policies. On the other hand, under a floating exchange rate regime, money supply is exogenous and as such can be controlled. The implication is that when exchange rates are fixed, international reserves have to be adequate to protect such rates. Conversely, when rates are allowed to float, the need for reserves is diminished. The monetary approach prescribes the adoption of appropriate domestic monetary/fiscal policies in conjuction with exchange rate variation to achieve equilibrium. However, it frowns at exchange rate volatility.

Although, monetary/fiscal policies were applied as instruments to manage foreign exchange resources before SAP, they were not the major policy thrust of government. However, with SAP, the notion of exchange rate endogeneity was embraced with the floating of the naira in the foreign exchange market. In addition, monetary and fiscal policies became the major aids of ensuring stability in the foreign exchange market.

What is clear from the above is that a mix of policies drawn from the various approaches have been applied to manage foreign exchange in Nigeria. The elasticity approach emphasised expenditure switching policies while the income-absorption approach prescribed both expenditure switching and expenditure changing policies. On the other hand, the monetary approach favours reliance on expenditure changing policies.

PART II
FOREIGN EXCHANGE MANAGEMENT IN THE PERIOD BEFORE THE STRUCTURAL ADJUSTMENT PROGRAMME (1970 - JUNE 1986)

The objectives of foreign exchange management during this period was to harness foreign exchange resources, prevent disequilibrating foreign exchange movements, preserve the nation's foreign exchange reserves and the international value of the domestic currency.

During the period, exchange control was the main instrument adopted to manage foreign exchange resources. The control measures applied derived mainly from the income-absorption approach. As the exchange rate was administratively determined, it was not an active

4 IMF OP CIT p.12

instrument for foreign exchange management. The administration of the exchange rate failed to isolate the economy from the vagaries of international trade, international price movements and above all it made it impossible for independent monetary policy initiatives to be effective. The basic framework for foreign exchange management was the Exchange Control Act of 1962 which was reinforced by the Economic Stabilisation (Temporary Provisions) Act, 1982. The 1962 Act made provisions for measures to increase foreign exchange resources, reduce the disbursement of foreign exchange and preserve the nation's international reserves. Other policies that were adopted were either in pursuance of the objectives of the 1962 Act or meant to reinforce the provisions of the Act. The specific policies that were applied during this period are as follows: trade and exchange controls, export promotion, external reserves diversification, external debt and exchange rate administration. The main ingredients of the policies which are discussed below derive mainly from the expenditure reduction aspect of the income-absorption approach.

1. Trade and Exchange Controls

Trade and Exchange controls were meant to manage judiciously available foreign exchange, promote the production and consumption of home-made goods and ensure that foreign exchange reserves are adequate to guarantee balance of payments stability. However, trade and exchange controls are cumbersome because of the massive policing and complex administrative framework required for a successful operation. Furthermore, control systems are effective in a society where corruption is resisted, where people are dedicated and leakages are either non-existent or are minimal. The application of trade and exchange controls in Nigeria during the review period were based on the need to tighten them during periods of crises and loosen them during periods of relative ease. This approach appeared to be in conformity with the Federal Minister of Finance assertion at the enactment of the 1962 Act, when he indicated that the act was conceived as a "fire extinguisher" meant to be reactivated at periods of crises. Thus, between 1970 and 1975, controls were liberalised but tightened progressively between 1976 and 1979. However, a policy of massive trade and exchange liberalisation was adopted in 1980 as a result of the relatively comfortable foreign exchange position in the preceding year. The disastrous consequence of this policy led to the dramatic decline in foreign exchange reserves starting from the second half of 1981. This led to the enactment of the Economic Stabilisation (Temporary Provisions) Act in April 1982. Control measures were progressively intensified up to June 1986, in a desperate effort to stem the massive outflow of foreign exchange and create an atmosphere conducive for the application of stabilisation policies. Trade and exchange controls which required that foreign exchange receipts be centralised in the Central Bank and deliberately attempted to limit the expenditure of the same come under the realm of the income-absorption approach.

2. Export Promotion

Since exports constitute a major determinant of foreign exchange inflow, the authorities have tried over the years to promote them. In addition, the high dependence of the economy on the external sector convinced the authorities that the sustainable path to economic growth lay in the enhancement of exports and the diversification of the export base. Thus, the export

promotion council decree 1976 was promulgated to give legal backing to ad-hoc incentives already in place. The decree created the Export Promotion Council and charged it with the promotion of Nigeria's non-oil exports and the diversification of the export base. To further boost the export of Nigeria's scheduled export commodities, the marketing boards were dissolved and replaced with commodity boards in 1977. The Federal budget of 1986 also contained proposals for the establishment of export free zones and import duty concessions on export manufacturing. The package of incentives that accompanied the budget proposals included among others, the retention of 25 per cent of export proceeds by exporters, liberalisation of import and export licensing procedures and the provision for the establishment of an export credit guarantee and insurance scheme. However, most of the key incentives to promote non-oil exports during the review period were not implemented. Export promotion which was meant to raise the level of export production fits adequately into the income-absorption approach.

3. External Reserves Diversification

Essentially, reserves diversification is meant to optimally apportion a nation's reserves assets among various reserve currencies so as to ensure maximum returns and minimum losses in case of fluctuation, while at the same time ensuring that liquidity problems are minimised in daily foreign exchange transactions. Nigeria's foreign exchange reserves which were held in four currencies hitherto, were diversified into nine in 1976 as a result of increased oil receipts. Part of the reserves which were held in sterling were redistributed to other currencies in that year and sterling ceased to be the major component of Nigeria's foreign exchange reserves (see Table 4).

4. External Debt Management

Although there was need to fund adequately the reconstruction effort of the Federal Government after the civil war, the compelling need to stem the rate of foreign exchange outflow led to the pegging of outstanding external debts at ₦1 billion. However, decree No. 30 of 1978 raised the ceiling to ₦5.0 billion. Before 1982, external debt management did not constitute a major problem for the overall management of foreign exchange resources. With the re-emergence of trade arrears in the year, due to the inability to finance payments on current basis, external debt became the focus of policy. As a result of the continuous build-up of payments arrears and the persistent dwindling of external reserves, two debt refinancing agreements were concluded in 1983. Under the refinancing agreements about $2,112.1 million worth of arrears were covered. The third refinancing agreement which commenced in November 1984 involved the issuance of promissory notes.

5. Exchange Rate Management

During the period under review, the exchange rate of the naira was administratively managed and backed up by control measures. The Nigerian pound was pegged to the British pound sterling before and immediately after the creation of the Central Bank of Nigeria. However, following the generalised floating of the major currencies in 1972, the Nigerian currency was devalued in February, 1973 by 10 per cent in sympathy with the dollar devaluation

of that year. This was meant to prevent an adverse balance of trade in Nigeria's external transactions and safeguard the external value of the naira since the level of reserves was relatively comfortable. Thereafter, both the pound sterling and the dollar were used as reference currencies, and a policy of progressive appreciation of the Naira against the weaker of the two currencies was adopted. Due to the adverse effect of this measure, it was discontinued. The need for a change in policy was particularly influenced by the 1982 re-appearance of trade arrears which proved difficult to tackle. Hence in 1981, a policy of gradual depreciation was embarked upon. The policy was meant to increase foreign exchange receipts through increased export volume and value, stem the outflow of foreign exchange and reduce the pressure on the balance of payments. During the period of administrative management of the naira and particularly between 1978 and 1985, the Central Bank used a basket of currencies of Nigeria's major trading partners as one of several indicators to determine the value of the naira. Others were the state of the balance of payments, level of reserves, foreign exchange supply and demand relationship, inflation and domestic output.

PART III
FOREIGN EXCHANGE MANAGEMENT UNDER SAP (JULY 1986 - 1990)

The pitfalls of exchange control let to its abandonment. Consequently, a market based system commenced in July 1986 with the structural Adjustment Programme (SAP). The SAP objectives include, the achievement of balance of payments and fiscal viability, the rationalisation of public enterprises through privatisation and commercialisation, the reduction in the level of unemployment and the attainment of sustained economic growth. To achieve the objective of balance of payments and fiscal viability, a market determined exchange rate mechanism was put in place, fiscal and monetary policies were tightened to be consistent with the achievement of balance of payments equilibrium. The key element of the SAP is the free market determination of the naira exchange rate through an auction system. Apart from the shift to market-determined exchange rates and exchange control deregulation, other policy measures adopted under the previous system were continued with modifications where necessary to accord with the policy framework of deregulation. The policies applied during this period were based largely on the income-absorption and monetary approaches. This is because, the policies emphasised increase in domestic output and foreign exchange receipts, curtailment of foreign exchange expenditure, domestic monetary stability and reliance on relative prices in the allocation of scarce foreign exchange resources. In specific terms, the measures adopted can be examined under the following:

Exchange Rate Management

The framework for foreign exchange management under the new dispensation, the Foreign Exchange Market (FEM), was conceived as a mechanism for the determination of an appropriate exchange rate for the naira in order to reduce the pressure on foreign exchange resources and stabilise the balance of payments. In effect, the exchange rate mechanism was expected to result in a more rational allocation and utilisation of foreign exchange resources and reduce foreign exchange volatility, thus making foreign exchange management less difficult. The major source of foreign exchange to the market is the Central Bank of Nigeria

which incidentally earns most of the nation's foreign exchange from crude petroleum exports. The main users of foreign exchange are the manufacturers who ironically contribute little to the pool of foreign exchange resources. This asymmetry has resulted in continuous pressure on official foreign exchange resources. Since the inception of the market determined system in September 1986, the naira has undergone substantial devaluation. However, the authorities have constantly adjusted the modalities of operating the system to make it more efficient in order to be able to realise the objectives for which it was set up. Thus in January 1989 the autonomous market was abolished and the inter-bank foreign exchange market (IFEM) emerge. A set of criteria were used to determine the exchange rate. Due to the persistent decline in the value of the naira, the Bureaux de Change was established in 1989 to enlarge the scope of the officially recognised foreign exchange market and make foreign exchange available to small users in a less formal manner. In addition, the Dutch Auction System (DAS) first operated in 1987 but abandoned in 1989 was re-introduced in December 1990. It was meant to check the sharp practices that led to the persistent pressure on the naira.

External Debt Management

In the area of external debt management, the policy restricting external debt acqusition to only key projects was retained. A debt conversion programme commenced in 1988 to further reduce the nation's external debt burden. Also, various debt rescheduling agreements have been concluded between Nigeria and the Paris and London Clubs of creditors aimed at restructuring the maturity pattern of debts falling due. The debt rescheduling negotiations are continuing.

Export Promotion

It was not until 1986 that real efforts were made to tackle the poor performance of the non-oil export sector. Apart from the generous incentives proposed in the Federal budget and the Export (incentives and miscellaneous provisions) Decree of that year, export licensing was abolished. In addition, the commodity boards were scrapped so as to make exports of non-oil commodities more competitive, the foreign currency domiciliary account scheme became operational and exporters were now allowed to retain 100 per cent of their export proceeds in their domiciliary accounts. To further boost non-oil exports, the Central Bank of Nigeria set up a Re-discounting and Refinancing Facility (RRF) in 1987. Under the scheme, banks that engage in export financing could recoup such funds from the Central Bank at the minimum rediscount rate, thus allowing them a margin over the commercial rates they charge exporters. The depreciation of the exchange rate was also considered as a measure that could boost exports.

External Reserves Diversification

Nigeria's external reserves were further diversified in 1987. However, the concentration of most of the reserves in dollars, indicated a shift in policy from mere diversification to liquidity. Since most of the nation's external transactions were effected in dollar, the holding of most of the reserves in the currency might have been justified. Nevertheless, the continuous slide of the dollar against other reserve currencies necessitated the shift to the pound sterling between

1989 and 1990 when the share of the dollar in Nigeria's reserves declined from 67.3 to 50.4 per cent with a corresponding rise in the share of the sterling from 21.9 to 42.5 per cent.

Demand Management Policies

To guide the foreign exchange market towards an appropriate exchange rate, tight monetary and fiscal policies were embarked upon by the authorities. Thus in 1989, the Federal government directed its Ministries and Parastatals to transfer their deposits from commercial and merchant banks to the Central Bank. Financial institutions were banned from granting loans on the basis of foreign guarantees. Loans already granted on that basis were recalled. The prescribed ceiling for credit expansion was reduced while cash reserve requirements, liquidity ratios and Central Bank's minimum rediscount rate were raised. In addition, the issuance of stabilisation securities commenced in 190 to mop up excess liquidity from the system, and thus reduce the effective demand for foreign exchange.

PART IV
APPRAISAL OF POLICY MEASURES UNDER SAP AND PROSPECTS FOR THE FUTURE

Policy measures applied under SAP were fashioned deliberately to, eliminate price and output distortions in the economy, reduce foreign exchange leakages and excessive outflow of foreign exchange, eliminate the over-valuation of the naira exchange rate in order to reduce the excessive demand for foreign exchange, increase domestic output and the supply of foreign exchange, stabilise foreign exchange transactions and guarantee external equilibrium without compromising the goal of domestic monetary stability. These policies were anchored on a flexible exchange rate mechanism propelled by market forces. To a large extent some successes have been recorded since SAP policies were put in place. Emphasis appears to have shifted from ad-hoc policy formulation designed to tackle problems as they emerged to policy consistency based on a forward looking approach. The realisation that the "fire extinguisher" approach to economic management was inimical to sound foreign exchange management is a major achievement of the current system. The freedom given to economic agents to determine the level of prices, output and the volume of foreign exchange transactions without encumberances is another good point of the market based system of foreign exchange management.

In real terms, the success of the new dispensation which has resulted in relatively more relaxed atmostphere for foreign exchange management can be measured by various economic indicators. For instance, foreign exchange receipts which dropped from $12310.2 million in 1985 to $6976.5 million in 1986 rose to $9562.1 million in 1990 (see table 1). Reserves import ratio also improved from 2.9 months in 1985 to 9.5 months in 1990 (see table 3). During the same period, the balance of trade, which dropped from $5.7 billion in 1985 to $2.8 billion in 1987, rose to $9.0 billion in 1990. This was achieved as a result of the consistent improvement in exports which averaged $7.4 billion between 1987 and 1989 before climbing to $14.7 billion in 1990 and the relative stability in the value of imports during the review period after it was brought down drastically from the high level of the early 1980s. The accommodation of unpaid claims on Nigeria under the short-term capital account in addition to the comfortable external trade position resulted in the consistent improvement in the overall balance of payments. The balance of payments improved from a surplus of $1185.0 million in 1989 to $2124.5 million in

1990. The system of payment under the current dispensation has eliminated payments arrears on current transactions due to the holding of disbursements within the limit of resources and the encouragement of autonomous foreign exchange transactions. The design of the new system which limits transactions in the foreign exchange market to current commitments is a resounding achievement. In real terms remarkable gains have been made. As a result of the impact of relative price adjustments, capacity utilisation which dropped to 38.9 per cent in 1986 as a result of the scarcity of foreign exchange inreased gradually as a result of increased local sourcing of raw materials and the more effective foreign exchange management mechanism. In 1989, capacity utilisation improved to 42.5 per cent before declining to 37.5 per cent in 1990 due to increased cost of sourcing raw materials both locally and in the international market. However, the performance of non-oil exports has not been encouraging. Non-oil exports declined from a high of $962.8 million in 1988 to $284.3 million in 1990 (see table 2). However, in terms of its composition, non-oil exports have rescorded some achievements.

Apart from traditional cash crop exports, the non-oil export list now include such new items like yams, kolanuts, cashew nuts, precious metals, ginger, vanilla, cars and detergents. The fact that cocoa remains the dominant non-oil export is a major problem of this sector. The initial over-valuation of the naira exchange rate has also been corrected. However, since the deep-seated problems of the external sector which necessitated the introduction of the market mechanism have not been corrected, an administered revaluation of the exchange rate is not a feasible option. However, debt servicing remained a major problem. The debt service ratio has remained high, rising from 25.7 per cent in 1988 to 33.1 per cent in 1990. The situation would have been worse were arrears on debt service payments not accumulated during this period. The industrial sector which consumes most of the nation's foreign exchange, over 60 per cent, has compounded the foreign exchange problem by its continued demand for the same share of foreign exchange while contributing insignificant amount to the pool of foreign exchange available to the economy. The gap between its demand and what it earns in foreign exchange is unreasonably large. Most of the non-oil export receipts are due to the export of unprocessed commodities and receipts due to services. The agricultural sector which should have been developed to provide the necessary linkage with the industrial sector through the provision of required raw materials to stem further the demand for foreign exchange has been less favoured. Allocation to this sector has remained at a level below 3.0 per cent since SAP commenced.

Apart from the traditional problems of a flexible exchange rate system such as inflation and exchange rate instability, the inadequacy of foreign exchange remained a critical factor for the success of the new approach to foreign exchange management. Over-dependence on crude oil as the principal source of foreign exchange earnings is a basic constraint on the nation's ability to expand the sources of its foreign exchange.

The adverse effects of the above mentioned constraints on the future of the current foreign exchange mechanism are enormous. For instance, the continuous depreciation of the naira exchange rate has contributed to the rise in the cost of production in the manufacturing sector, leading to the overall rise in prices. In addition, the inadequate supply of foreign exchange to the official segment of the foreign exchange market due to low receipts has led to a situation where there exists a spill-over of demand from the official to the parallel market. This has

resulted in the substantial divergence between the rates in the two markets (see table 5). As a result of the persistent excess demand for foreign exchange caused by foreign exchange shortage and excess liquidity in the domestic economy and the activities of speculators and arbitrageurs, the exchange rate will continue to depreciate if left entirely to market forces. This is only a natural consequence of the inter-play of market forces. The prospects for improving the value of the domestic currency and ensuring stability in the foreign exchange market will continue to elude the authorities under the current system if the basic problems are not tackled. However, if adequate attention is devoted to improving the supply of foreign exchange through policies greared at stimulating output of both traded and non-traded goods which may help to cut down on imports and excess liquidity in the economy is sufficiently mopped-up, foreign exchange would be more adequate to service the economy. It will be possible to achieve temporary stability in the foreign exchange market with the mopping-up of excess liquidity. However, since improvement in the supply of foreign exchange will take a long time to come through, effective realisation of the objective to reduce pressure on foreign exchange resources cannot be assured under the current situation. The prospects for a radical improvement in foreign exchange resources are therefore not very bright. Improvement will be gradual and would depend on the effectiveness of supply side policies. However, when the petrochemical, liquified natural gas and Oso condensate schemes start generating foreign exchange, the pressure would be reduced considerably.

PART V
RECOMMENDATIONS FOR ENSURING SUSTAINED REDUCTION OF PRESSURE ON FOREIGN EXCHANGE RESOURCES

Measures to reduce pressure on foreign exchange resouces are articulated around supply, demand and exchange rate measures.

These are examined below.

A Supply Side Measures

To increase the supply of foreign exchange to the economy, current measures to stimulate non-oil exports should be vigorously pursued. In particular, the diversification of the non-oil export base should be intensified in order to reduce reliance on the oil sector and raise the level of non-oil receipts. Exporters should be allowed to exchange their foreign exchange earnings at any source of their choice. Export ban as a measure to stimulate local processing of agriculatural commodities should not be a deliberate policy stance. The processing of traditional commodity exports can better be encouraged through generous incentives.

Government agencies dealing with the promotion of Nigeria's exports should be more aggressive in sourcing favourable markets for our exports. In addition, the packaging and quality of Nigeria's exports should be enhanced to make them internationally competitive.

In order to generate additional exports and ensure an overall conservation of foreign exchange resources, the level of domestic output should be raised. The increased production of both tradeable and non-tradeable commodities would reduce pressure on foreign exchange resources. The agricultural and industrial sectors of the economy need special attention in this regard. This is because the development of these sectors is a necessary condition for promoting

economic growth. With increased agricultural production, primary commodity exports would increase and surpluses from this sector could be traded as raw materials for the industrial sector which would then cut down on its demand for imports. The implied reduced cost of production from local sourcing of raw materials may place the industrial sector in a competitive position in the arena of international trade.

B. Demand Side Measures

The demand management policies in place, especially the one dealing with issuance of stabilisation securities, need to be re-examined. The allocation of stabilisation securities to banks based on the extent of their excess liquidity may not result in a permanent reduction in the demand for foreign exchange, unless the exercise is carried out routinely and under a comprehensive framework that does not give room for liquidity adjustments. Experience has shown that when excess liquidity is withdrawn from the banking system, the exchange rate appreciates during the period and after a short time the exchange rate starts to depreciate again. This is so because banks that are hard pressed for cash are able to get relief from those that are not experiencing liquidity problems through inter-bank dealings. In the light of the above, the issuance of stabilisation securities should be done more routinely to reduce the ability of the banks to adjust their liquidity positions. As a lasting measure, the issuance of stabilisation securities should be considered within the wider framework of open market operations. Overall, monetary policy stance should continue to be tight. However, if credit ceilings are imposed, interest rates should be freed but liquidity ratio and cash reserve requirements could be raised. On the other hand, if credit ceilings are not imposed, interest rates could be regulated and accompanied with restrictive liquidity and cash reserve requirements: As a complementary measure, expansionary fiscal policy should be discouraged. This is because expansionary fiscal policy would lead to increased demand for foreign exchange through its multiplier effect on money supply which increases effective demand for foreign exchange. The imposition of high tariffs on non-essential imports should be considered so as to further reduce the demand for foreign exchange. In addition, debt service payments should be made less burdensome by negotiating a comprehensive multi-year rescheduling programme for Nigeria's outstanding debts and pushing for debt reduction concessions like the ones already granted to Poland and Egypt by the Paris Club of Creditors. The policy of economic diplomacy being pursued by the government would assist in this direction.

To permanently reduce the problem of foreign exchange scarcity, local scourcing of raw materials should be encouraged and the domestic capital goods industry should be developed so as to reduce the need for imports. This is informed by the data for foreign exchange allocation which indicated that disbursement to the industrial sector took more than 60 per cent of total foreign exchange put up for sale by the Central Bank since September 1986. The need to reduce foreign exchange allocation to the industrial sector in the long term is further reinforced by the the fact that the industrial sector continues to demand most of the foreign exchange put up for sale by the Central Bank while its contribution to the pool of foreign exchange available to the econonv is negligible.

C. Exchange Rate Measures

A fixed exchange rate system encourages inefficiency and makes movement towards short-run equilibrium impossible. On the other hand, a freely floating exchange rate system is usually unstable, inflationary and impairs corporate decision making when not subjected to some form of regulation. The two extremes may not be ideal for any economy. The exchange rate is likely to be more ideal somewhere between the two extremes. To avoid the problems with the two systems, the exchange rate should be allowed to float within a band. There should be a lower and an upper band. The divergence between the bands should not exceed 5 per cent. The band of 5 per cent was arrived at from the observed movement in the naira exchange rate in the official market in 1990 and during the first half of 1991. Between April and May 1990, the exchange rate depreciated by approximately 5 per cent. In November and December, there was a depreciation of 4.4 per cent. However, during the first half of 1991, the naira exchange rate fluctuated violently between +6.6 and -7.9 per cent. If stability is the short term objective of exchange rate policy, the scenario shown by the first half data for 1991 cannot be relied upon. As a result, the 1990 data which were relatively less volatile were relied upon. The prescribed band should be operated only when the exchange rate has approached the theoretic equilibrium which could be determined through the purchasing power parity (PPP) in conjunction with movement in othere conomic variables. Such economic variables like the balance of payments, external reserves, money supply and domestic production are relevant in this case.

The need to move the exchange rate towards and equilibrium level before fixing a band is informed by the desire not to leave the naira exchange rate at a permanently undervalued and highly depreciated level. The movement towards a realistic exchange rate could be aided by restrictive monetary and fiscal policies. The exchange reate so determined through rational approaches should be taken as the central rate around which the 5 per cent band would be applied with a fluctuation range of ± 2.5 per cent. The range of the band should not be too narrow so as not to deviate too much from the freedom the market mechanism is supposed to entrench in the new system. In addition, if the band is too narrow, there would be a tendency towards a fixed exchange rate regime. The main attractions of determing the exchange rate within prescribed bands would be the reduction in wide exchange rate depreciations, the curtailment of the inflationary effect of persistent exchange rate depreciations and the elimination of speculative foreign exchange dealings.

Since the private sector which demands most of the foreign exchange supplied by the Central Bank contributes little to the pool of foreign exchange available to the economy and since the Central Bank is the sole supplier of foreign exchange to the foreign exchange market, it should not shy away from using its monopoly power. In this regard, the Central Bank can determine the price it wants to sell its foreign exchange and the banks would be allowed to determine what they want to pay subject to the 5 per cent band.

To further liberalise the foreign exchange market, the Bureaux de Change should be allowed to finance imports from their funds that are usually sourced autonomously.

PART VI
SUMMARY AND CONCLUSION

The paper examined foreign exchange management in Nigeria during the period preceding SAP and since the inception of SAP.

The art of foreign exchange management which is the main focus of this paper is a conscious attempt to harness foreign exchange resources, deploy them to service the economy and to meet other international commitments while saving some to raise the level of international reserves. Such reserves could be used to finance temporary payments difficulties and to safeguard the international value of the domestic currency.

Since foreign exchange which is a means for settling international transactions is earned and disbursed in the course of undertaking international transactions, there is a close link between it and the balance of payments which records transactions between the residents of one economy and the rest of the world. As a result, the standard theories of the balance of payments, the elasticity, the income-absorption and the monetary approaches were used as the theoretical basis for examining foreign exchange management in Nigeria during the review period. The elasticity approach emphasised expenditure switching policies while the income-absorption approach prescribed both expenditure switching and expenditure changing policies. The monetary approach advocates domestic monetary stability. It also favours the application of expenditure changing policies and concludes that although exchange rate variation is necessary for economic adjustment, its endogeneity is assured when monetary policy is right.

In the pre-SAP era, the 1962 exchange control Act was the basic framework for foreign exchange management in Nigeria. The Act made provisions for measures designed to increase foreign exchange resources, reduce the disbursement of foreign exchange and preserve the nation's foreign exchange reserves. The policies applied during this period derived mainly from the income-absorption approach. During this peroid, exchange controls were not tightened consistently. They were tightened during periods of crises and loosened during periods of relative ease. The exchange rate was administered during this period and as such, it was not an active policy instrument. The administration of the exchange rate backed by an arsenal of controls that were often circumvented led to the over-valuation of the exchange rate and a massive outflow of foreign exchange.

With the SAP period, a market determined system replaced the rigid controls reminiscent of the pre-SAP era. The objectives of SAP include the achievement of balance of payments and fiscal viability and sustained economic growth. To achieve the objective of balance of payments and fiscal viability, a market determined exchange rate mechanism was developed with the commencement of foreign exchange auctioning through the foreign exchange market in September 1986. Complementary monetary and fiscal policies were also applied to enable the naira attain a realistic level. Essentially, exchange controls were dismantled and the exchange rate became flexible. The policies adopted during this period to mange foreign exchange resources were drawn mainly from the income-absorption and monetary approaches.

The main achievements of the market determined system are; the elemination of payments arrears since transactions are done on current payment basis, the widening of the non-oil

export base, increased local sourcing of raw materials and improvement in the balance of payments and capacity utilisation. However, the system has not succeeded in improving significantly non-oil receipts and the economy is yet to be diversified away from over dependence on crude oil exports. Another problem is the wide disparity between foreign exchange allocation to the industrial sector and its contribution to the pool of foreign exchange available to the economy. In addition, the allocation to the agricultural sector which should have provided the necessary linkage with the industrial sector is dismal at less that 3 per cent. The traditional problems of exchange rate flexibility such as inflation and exchange rate volatility coupled with inadequacy of foreign exchange resources have compounded the nation's foreign exchange problem.

To ameliorate the situation, current measures to stimulate non-oil exports should be intensified, export ban should not be a deliberate policy stance but generous incentives should be given to encourage local processing of these commodities, the level of domestic output should be raised to provide more tradeables in order to raise the level of foreign exchange receipts and cut down on imports. On the demand side, the issuance of stabilisation securities should be carried out within the framework of open market operations so as to reduce the ability of the banks to seek financial accommodation. A tight monetary policy should continue to be pursued and fiscal policy should be in consonance so as not to create countervailing effects. To achieve; a realistic exchange rate, reduced speculative influences on foreign exchange and the elimination of the tendency towards persistent exchange rate depreciation, bidding for foreign exchange should be within a band of 5 per cent with the central rate determined through rational approaches. This system, while not encouraging a fixed exchange rate regime, could eliminate exchange rate speculation, reduce the influence of foreign exchange arbitrageurs in the foreign exchange market and make planning easier for both users and managers of foreign exchange. It will also reduce the inflationary expectations of exchange rate flexibility.

<u>TABLE 1</u>

FOREIGN EXCHANGE FLOWS THROUGH THE CENTRAL BANK
($' MILLION)

YEAR	INFLOW			OUTFLOW			
	OIL	NON-OIL	TOTAL	VISIBLE IMPORT	INVISIBLES	TOTAL	NETFLOW
1970	N.A	N.A	901.6	N.A	N.A	829.9	+71.7
1971	N.A	N.A	1,495.3	N.A	N.A	1,315.6	+179.7
1972	N.A	N.A	1,818.5	N.A	N.A	1,877.5	-59.0
1973	2,605.6	793.7	3,399.3	2,483.8	272.1	2,755.9	+643.4
1974	7,067.4	1,374.8	8,442.2	1,260.0	2,213.0	3,473.0	+4,969.2
1975	7,719.7	1,197.6	8,917.3	8,844.2	115.3	8,959.5	-42.2
1976	8,698.0	1,804.0	10,502.6	8,168.2	2,846.1	11,014.3	-511.7
1977	9,975.9	2,027.9	12,003.8	10,625.4	2,182.1	12,807.5	- 803.7
1978	8,287.5	4,250.9	12,538.4	11,244.0	3,505.1	14,749.1	-2,210.7
1979	14,503.5	2,847.5	17,351.0	10,764.9	3,515.5	14,280.4	+3,070.6
1980	22,932.6	3,046.7	25,979.3	17,815.9	3,770.3	21,586.2	+4,393.1
1981	17,471.5	3,977.7	21,449.2	22,121.5	4,322.3	26,443.8	-4,994.6
1982	12,178.5	2,772.7	14,951.2	14,245.3	2,783.2	17,028.5	-2,077.3
1983	10,192.5	1,486.7	11,679.2	7,742.0	4,353.6	12,095.6	-416.4
1984	11,016.1	1,105.3	12,121.4	6,810.5	4,846.4	11656.9	+464.5
1985	11,367.2	943.0	12,310.2	5,623.7	6,107.6	11,731.7	+578.9
1986	5,742.5	1,234.0	6,976.5	3,114.8	3,367.1	6,481.9	+722.2
1987	4,659.3	851.0	5,510.3	3,945.1	1,367.7	5,312.8	+197.5
1988	4,924.9	304.3	5,229.2	3,247.5	2,314.4	5,561.9	-332.7
1989	5,912.3	1,072.4	6,984.7	2,202.3	3,634.7	5,837.0	+1,147.7
1990	7,437.1	2,125.0	9,562.1	2,508.3	4,929.3	7,437.6	+2,124.5

N.A = Not Available

TABLE 2

AUTONOMOUS FOREIGN EXCHANGE INFLOW
($' MILLION)

YEAR	NON-OIL EXPORTS	OTHERS	TOTAL
1986[1]	47.1	180.5	227.6
1987	522.0	540.8	1,062.8
1988	962.8	279.9	1,242.7
1989	138.1	860.4	998.5
1990	284.3	1,167.8	1,452.1

1/ Data from October to December 1986

TABLE 3

SELECTED EXTERNAL SECTOR VARIABLES[1]

(₦ MILLION)

PERIOD	EXTERNAL DEBT OUT-STANDING	DEBT SERVICE	EXPORT	IMPORT	EXTERNAL RESERVES	MONTHLY IMPORTS	AVERAGE MONTHSOF IMPORTS	NO. OF SERVICE RATIO	DEBT BALANCE OF PAYMENTS[3]	AVERAGE OVERALL RATE $ = ₦1.00
1970	488.8	31.0	885.4	756.4	156.4	63.0	2.5	3.5	+58.6	1.4000
1971	214.5	29.9	1,293.4	1,078.9	281.4	89.9	3.1	2.3	+127.8	1.4400
1972	263.4	26.2	1,434.2	990.1	243.6	82.5	2.9	1.9	-39.6	1.5200
1973	276.9	30.8	2,278.4	1,224.8	378.0	102.1	3.7	1.4	+174.4	1.5200
1974	322.4	29.1	5,794.8	1,737.3	3,460.8	144.8	23.9	0.5	+3,102.2	1.5891
1975	349.9	32.7	4,925.5	3,721.5	3,380.1	310.1	10.9	0.7	+157.5	1.6244
1976	374.6	34.4	6,751.1	5,148.5	3,057.6	429.0	7.1	0.5	-339.9	1.5960
1977	496.9	25.6	7,630.7	7,093.8	2,518.7	591.1	4.3	0.4	-527.2	1.5466
1978	1,252.1	160.8	6,064.4	8,211.7	1,192.5	684.3	1.7	2.7	-1,293.6	1.6482
1979	1,611.5	182.9	10,836.8	7,472.5	3,043.0	622.7	4.9	1.7	+1,868.9	1.6591
1980	1,866.8	101.6	14,186.7	9,095.6	5,445.2	758.0	7.2	0.8	+2,402.2	1.8286
1981	2,331.2	518.6	11,023.3	12,719.8	2,424.8	1,060.0	2.3	4.7	-3,020.8	1.6534
1982	8,819.4	775.2	8,722.5	12,565.5	1,026.5	1,047.1	1.0	8.9	-1,398.3	1.4856
1983	10,577.7	1,335.2	7,612.3	9,723.0	725.2	810.2	0.9	17.5	-301.3	1.3822
1984	14,536.6	2,640.5	9,088.0	7,178.3	1,080.0	598.2	1.8	29.0	+354.8	1.3085
1985	17,290.6	3,718.0	11,720.8	7,062.6	1,641.1	588.5	2.9	31.7	+349.1	1.1206
1986	41,451.9	2,502.2	8,920.5	5,983.6	3,587.4	498.6	7.2	28.0	-796.4	0.7866
1987	100,789.1[2]	3,590.6	30,239.9	17,861.7	4,643.7	1,488.5	3.1	11.9	+159.2	0.2519
1988	146,076.4	8,012.5	31,192.8	21,445.7	3,272.7	1,787.1	1.8	25.7	-2294.1	0.2204
1989	240,393.6	13,382.0	57,971.2	30,860.2	13,457.1	2,571.7	5.2	23.1	+8,727.8	0.1358
1990	297,894.3	34,414.6	109,886.1	45,717.9	34,953.1	3,809.8	9.2	33.1	+18,498.2	0.1244

1/ End of Period
2/End of October
3/Adjustment for Valuation changes

Source: Federal Ministry of Finance and Central Bank of Nigeria. Data on outstanding debt from 1970 through 1981 relate to Federal debt only.

TABLE 4

COMPONENTS OF NIGERIA'S EXTERNAL RESERVES

(PER CENT)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	19
Gold IMF Gold Trench and OIL FAULITY	15.4	7.9	9.6	10.7	1.1	1.2	1.4	1.3	27.1	7.8	2.6	10.0	1.8	2.4	6.5	1.1	0.5	0.4	0.5	0.2	0
SDRS	-	7.9	13.4	9.5	1.1	1.2	1.7	2.2	4.6	2.6	3.6	11.3	2.7	10.2	0.5	0.5	-	-	-	-	
Sterling Assets	75.4	73.9	54.0	59.1	57.6	33.1	14.7	16.5	14.0	4.9	22.0	15.1	18.8	17.3	16.6	7.1	4.9	9.1	5.8	21.9	42
US $ Assets	9.2	10.3	23.0	20.4	38.8	41.8	20.9	15.8	14.6	25.3	23.5	19.7	39.0	33.9	51.2	58.2	76.2	69.6	66.6	67.3	50
DM Assets	-	-	-	0.3	1.3	12.5	26.6	30.5	14.8	37.1	22.8	13.2	6.3	5.4	6.9	6.2	5.4	5.0	9.1	2.9	0
French Franc	-	-	-	-	0.1	3.9	6.0	4.0	5.0	7.7	6.8	4.5	13.3	1.1	0.2	9.3	3.5	8.0	5.0	5.8	5
Canadian Dollar	-	-	-	-	-		15.0	12.7	2.1	2.0	1.4	2.1	1.0	0.9	0.6	0.6	0.3	0.2	0.2	-	
Japanese Yen	-	-	-	-	-	-	7.3	9.2	4.5	5.8	9.1	9.6	-0.5	-0.3	-	1.3	-	-	-	-	0
Swiss Francs	-	-	-	-	-	-	1.5	1.9		6.4	6.8	9.4	12.8	23.4	12.4	12.5	3.3	2.7	3.4	0.4	
Belgian Francs	-	-	-	-	-	-	3.5	3.9	9.2	0.3	0.8	1.5	3.1	3.8	1.8	0.4	0.2	0.4	0.6	0.1	
Dutch Gulger	-	-	-	-	-	-	1.4	1.4	1.8	2.5	0.6	2.7	1.7	1.9	2.0	1.9	3.4	2.5	3.7	0.3	
Others	-	-	-	-	-	-	-	0.6	2.3	-2.4	-	0.9	-	-	1.3	0.9	2.3	2.1	5.1	1.1	0

TABLE 5

COMPARATIVE NAIRA EXCHANGE RATE

PERIOD	AVERAGE OFFICIAL RATE	AVERAGE AUTONOMOUS RATE	AVERAGE PARALLEL RATE	AVERAGE BUREAU DE CHANGE RATE
December 1987	4,1665	4,6828	4,6000	-
December 1988	5,3530	8,2856	8,3500	
December 1989	7,6221	-	9,4600	9,4800
January 1990	7,8620	-	9,5000	9.5100
February 1990	7.9011	-	9.4100	9.4900
March 1990	7.9388	-	9.2000	9.2600
April 1990	7.9400	-	9.2000	9.2700
May 1990	7.9400	-	9.2600	9.3000
June 1990	7.9424	-	9.4400	9.4700
July 1990	7.9523	-	9.7900	9.8800
August 1990	7.9623	-	9.6200	9.4700
September 1990	7.9743	-	9.7200	9.7800
October 1990	8.0089	-	9.8500	9.9100
November 1990	8.3247	-	10.1300	10.1500
December 1990	8.7071	-	10.1600	10.0800

* The autonomous market was abolished in January, 1989.

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